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MEMORANDUM

TO: Michael Mazerov
Director of Information
Multistate Tax Commission

DATE: June 3, 1997

FILE: 410:BWT:MTC8

FROM: Brian W. Toman

SUBJECT: MTC Working Draft Proposals
Definition of a Unitary Business
Definition of Business and Nonbusiness Income

Below are the Franchise Tax Board staff line-by-line comments on the captioned working draft proposals.

DEFINITION OF A UNITARY BUSINESS

Line(s)

- 8 Suggest add "which require apportionment of business income" after "States."
- 17 Suggest define "reporting person." Creates an ambiguity because partnerships are reporting entities. What happens to 18 Cal. Code Regs. section 25137-1 (dealing with partnership reporting of distributive income) in this context?
- 20,21 Suggest define "common ownership or control." (Note: If it means the same as California's new unity of ownership statute RTC Section 25105, the language from that statute may serve as the definition.)
- 25 Suggest add "two or more business entities engaged in..." after "of" and after "business" add "and apportion income to respective states."
- 28 Suggest explain the phrase "sufficiently related."

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- 35 Suggest define "diverse business." California has informally defined a diverse business as one which is not horizontally or vertically integrated.
- 41-44 Appears to misstate of language in Container. Diversification of portfolio militates against the existence of a unitary business, it is not a factor pointing toward unity.
- 46,47 Suggest define "commonly owned or controlled." (See above)
- 61 Suggest define "Allocated." This is the first time the word appears and it may not be commonly understood.
- 65 What is the case or other authority for a presumption of unity "that arises from the structure [undefined] of an enterprise as a single entity"? Is this merely opinion?
- 86-87 Suggest strike sentence beginning with "This sharing or exchange of value..." It appears to be a misstatement. The sharing or exchange of value spoken of in the Container opinion is incapable of precise measurement.
- 90-97 Suggest strike beginning with "Evaluation of the objective..." This appears to be redundant given the preceding sentence. Also, what is meant by "investment" and "passive activity." "Passive activity is likely to lead to a comparison with passive activity loss of federal income tax law.
- 99,100 What is "unity of control?" Is it unity of ownership?
- 101-109 In referring to the three tests, it is suggested that court cases be cited for all three tests which gave rise to them, or cite to none at all. Only the Mobil case is cited. If three tests are to be discussed, they should be discussed with thoroughness. Of all alternatives, it is suggested the best approach would be to skeletally cite to the three tests, and let the balance of the regulation focus on the "factors" which make up unity, without reference to whether a given factor satisfies a given test.
- 111-114 Should the holding company issue be resolved before the working draft is completed and included in it. Is it possible that, for example, a holding company provision would conflict with the working draft provision unless they are resolved simultaneously?

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- 118 Add "or" between contribution/dependency. It is suggested it is not necessary to state these are in the disjunctive, this appears self-evident from the phrase "contributes or depends upon".
- 126,127 It is suggested there is some minimum level of unity of operation or unity of use otherwise there is no unitary business. It is suggested a more appropriate phrase would be "there is no universally applicable level of unity of use or unity of operation."
- 128,129 This appears to be a perplexing statement. One can distinguish between functional integration, centralized management, and economies of scale, even though certain relationships may satisfy one or more of the factors.
- 130 Suggest replace "may satisfy" with "support a finding for."
- 132 Suggest change "prescribed level" to "universal applicable level". See line 126, above.
- 137 Suggest after "single" add the word "unitary."
- 138 Suggest italicize "Mobil".
- 139, 140 Suggest replace "operation" with "activity." PASSIM. "Activity" is more descriptive of a single unitary element than "operation" which connotes multiple activities.
- 142-147 What is the relevance of this sentence? Isn't a finding of unity based on factors present, not factors absent? Suggest the sentence be stricken.
- 150 The term "Pooling" needs a definition. Otherwise, suggest use of the term "Sharing" because it is more descriptive of a unitary relationship, such as contribution and dependency. PASSIM.
- 163 It is suggested the word "indicate" is ambiguous. It is suggested it be replaced with "may provide an indication of..." PASSIM. "Indicates" can be taken to mean "shows," "demonstrates," "establishes," or "satisfies a condition." Where used, the term is probably intended to convey a concept more like "is an additive factor pointing toward," or evidence which "tends to support a finding of." This apparent ambiguity can probably be improved by substituting "may provide an indication of" wherever "indicates" appears.

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- 168 It is suggested that "vertically integrated enterprise" be defined.
- 207 It is suggested that "Operational purpose" be defined.
- 221-224 Phrase is confusing. Centralization of management exists even though the principal elements of manage are de-centralized? This appears internally inconsistent. What is the source for this proposition? Consider striking unless there is authority for this proposition.
- 226 Suggest "implicit" understandings are not auditable as they are not plainly apparent or expressed. Is something else meant here, like "informal" which may be proven by testimony?
- 229-231 This sentence is not consistent with California case law. Centralized management per se provides a flow of value sufficient to support a finding of unity under Mole-Richardson (1990) 220 Cal. App. 3d 889. The management does not have to "integrate" the businesses themselves. Is this sentence requiring the "functional integration" of diverse business entities? If so, that position has been rejected by the California courts.
- 235 It is suggested "benefit of the whole" be defined.
- 236-241 This listing of indicators of centralized management appear to describe items that will exist with every large corporation and therefore appear to cast centralized management in very broad terms. Another view would be a less broad "operational involvement" standard would be required to indicate centralized management. What is the intent of staff with this sentence?
- 257-263 Approval of significant expenditures and a centralized cash management are probably commonplace among large corporations and therefore appear to cast stewardship in narrow terms. Another view would be a broader standard of stewardship responsibilities requiring approval of all or most expenditures beyond those that are significant before mere stewardship is exceeded. What is the intent of staff with this sentence? It is suggested "significant" be defined.
- 264-270 We are somewhat confused by this section. (1) Why does staff feel that corporations engaged in the same general line of business and corporations that are vertically

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integrated businesses (i.e., steps in a vertical process) in and of itself indicates centralized management? The management teams of the corporations may be not be same people that have anything to do with each other. (2) If the same general line of business means horizontal integration, should the degree of centralized management needed to find unity be the same for horizontal as well as vertical integrated businesses. It seems to us centralized management is more important for a finding of unity in a horizontal integration setting because unifying factors present in a vertical integration setting may be absent in a horizontal integration setting. (3) Does this section intend to indicate the transfer of knowledge and expertise itself is centralized management? (3) What is the authority for the propositions contained in this section?

There is authority in California (Appeal of Credit Bureau Central) that held an inference is created that expertise is transferred if central management is present in a same line of business setting. Should this thought be included in this section?

- 71-278 What does "necessarily centralized" and "will likely integrate" mean? Why does staff feel that management of a single entity is "necessarily" centralized? We have seen situations where a single corporation contained several divisions that had different managers for each division that did not operate in a centralized manner.
- 281 Question as to whether realizing economies of scale from centralized administrative functions is properly set forth in this section. It has been suggested that there should be a comparison of the cost savings to the income which would be subject to apportionment. See Keesling and Warren, "The Unitary Concept in Allocation of Income," 12 Hastings L.J., 43, 52 (1960): "Central accounting, for instance, may result in some savings, but in most instances the amount is trifling in comparison with the income [involved]. Alone considered it is too weak a connecting link to bind one business, what would otherwise, from an operational standpoint, be considered separate businesses." See also Woolworth, 458 U.S. 354 at 359, fn.22.
- 294-295 Suggest consider striking "accounting", "tax administration" and "financial reporting" which are arguably insignificant under Woolworth, above.

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- 302 Suggest consideration of a preamble indicating: (1) the interplay between evidence and presumptions (e.g., a presumption is not evidence, a presumption only applies in the absence of evidence, comparative probative value of evidence verses a presumption), (2) the legal effect of the presumption (e.g., does it affect the burden of going forward with the evidence or does it shift the burden of proof), (3) if the presumption affects the burden of proof, what is the level of evidence that is needed to prove a presumed condition is not in fact true, and (4) whether a presumption is assertable and rebuttable by both a state and a taxpayer.
- 304-308 Suggest "clear and cogent evidence" be defined (is this another way of stating "clear and convincing"). Would it be appropriate for the individual state law to control the definition of burden? Shouldn't the rebuttal provision also apply to a state if a taxpayer can also assert a presumption.
- 312 Suggest replace "multistate grocery operation" with "a chain of multistate grocery stores." This is just a choice of words, but the words suggested may be more factually accurate.
- 317 Suggest replace "based upon" with "produced from." Again, just a choice of words, but the words suggested may be more descriptive of the actual activity.
- 318 Suggest add "presumed" after "is."
- 319-321 These lines appear to be inconsistent with lines 264-270.
- 322-325 What is the authority for this section? This section appears to indicate that, for example, all diverse businesses operated as divisions of a single corporation are presumed to constitute a single unitary business.
- 329 Suggest the term "strong" within the phrase "strong central management" be defined. Does "centralized management" beginning at line 213 mean the same as "strong central management"? Clarification may be in order.
- 336-337 Suggest consider deleting "accounting", "personnel", "insurance" and "financing" for the same reasons set forth in comment on lines 294-295.

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343-356 Suggest consider if this section is inconsistent with the proposition that each year stands on its own from a factual standpoint. If this section is retained, suggest insert "under substantially the same facts" after the word "state" on line 345.

DEFINITION OF BUSINESS INCOME

General Comments: (1) This regulation propounds the existence of two tests for business income: a transactional test and a functional test. It is suggested examples be provided to illustrate satisfaction of both tests. (2) How is this working draft to be used by a state where the functional test is not the law? (3) What is the intended impact of the working draft with respect to provisions similar to California's regulation section 25120(d) (proration of deductions among trades or businesses and nonbusiness income)?

Line(s)

- 50-54 Does this section state a rule or a presumption? If it is a presumption, it should be so stated. Also, if a presumption, the same considerations listed on the definition of unitary business working draft concerning line 302 are relevant here (i.e., preamble indicating (1) the interplay between evidence and presumptions (e.g., a presumption is not evidence, a presumption only applies in the absence of evidence, comparative probative value of evidence verses presumption), (2) the legal effect of the presumption (e.g., does it affect the burden of going forward with the evidence or does it shift the burden of proof), (3) if the presumption affects the burden of proof, what is the level of evidence that is needed to prove a presumed condition is not in fact true, and (4) whether a presumption is assertable and rebuttable by both a state and a taxpayer). Also, suggest "clear and cogent" evidence be defined.
- 63 Suggest replace "actual" with "specific." This is just a choice of words, but the suggested word may be more focused.
- 65-74 What is the objective of this section? It appears to broaden the "transactional test?" If so, what is the authority for this section. Suggest an example be provided. Also, do the phrases "frequently occurring transactions", "regular course of that trade or business" and "customary in the kind of trade or business being conducted" all mean the same thing? If not, there should be some explanation of the differences.

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- 82 Suggest add "if not converted to nonbusiness use" after "property."
- 83 Suggest define the language "...integral, functional, necessary, or operative...." What does "necessary" add that is not covered by the other words? Also its is suggested lines 79-85 should be part of the text at end of line 78 instead of a separate section.
- 90 Suggest add "and if not converted to nonbusiness use" after "or was used."
- 99-109 It appears from a logical sequence perspective that the entire section should be moved to the end of line 85.
- 102 Suggest add "and not converted to nonbusiness use" after "was held."
- 110-114 It appears this section is redundant with line 62.
- 115-120 This section can be viewed as elevating a taxpayer's filing position to the point where it can supplant, via a presumption, objective facts concerning business or non-business treatment. Is this the intent of the section?
- 136 Suggest an insert illustrative example be provided.
- 138-155 This section appears to not state a rule, but an expression of policy and rationale. Is it necessary and appropriate in a regulation?
- 158 Suggest insertion of examples of nonbusiness income.
- 163-165 Suggest replacing the last sentence with "The following are some examples which illustrate the business or nonbusiness character of income." Consider labeling examples as meeting either the transactional or functional tests, and why they meet such tests. Consider adding new examples.
- 169 "Incidental" is ambiguous. In light of more focused definitions of business income via the transactional and functional tests the word "incidental" is nondescriptive.
- 181-189 Suggest striking example for same reasons as stated concerning line 169.

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195-199 Suggest striking example for same reasons as stated concerning line 169.

225-226 Suggest add "and was not converted to non-business use" after "in." Is this phrase intended as a rule or as a presumption? If a presumption, see comments concerning lines 50-54.

259-269 It appears the purpose of this example is to illustrate that the sale of a segment of a unitary business generates business income. This appears to be an obvious principal. Does this merit an example.

275 See comment regarding "necessary" concerning line 83. PASSIM.

313-326 This example can be read at least two ways. It can be read to illustrate that the regulatory presumption of business income applies when there is no evidence of source of funds or intent for use. It can also be read that funds of unknown origin, and which have not been earmarked for any purpose, are characterizable as business income merely because they are available for business use.

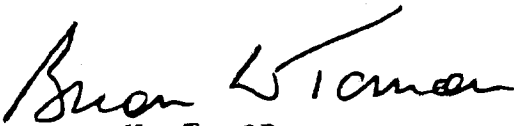
If the intent is the former, is the final sentence needed in that it states the obvious? If it is the latter, what is the authority which supports an "available for use" theory of business income?

If the intended meaning is an "available for use" concept, there appears to be several problems. First, funds which are arguably "available" for business use are equally arguably available for nonbusiness use, or for that matter, acquisition of a non-unitary business. Second, this example is arguably internally inconsistent with the draft regulation's definition of the functional test. The definition of the functional test arguably requires an intangible in order to characterize the income generated therefrom as business income: "...an integral, functional, necessary, or operative component to the taxpayer's trade or business operations..." If the funds have not been earmarked or otherwise identified for business use, what makes them characterizable as business income under that standard? Third, such an arguably overbroad definition of business income can possibly run afoul of U.S. Woolworth's admonition against unitary treatment for assets with potential operational use and against Allied-Signal's statement that

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there is some limitation to the characterization of business income.

- 343 Suggest replace "moneys" with "funds." This is just a choice of words but it is suggested "funds" is a more commonly used word.
- 381 See comment concerning "necessary" on line 83." PASSIM.
- 397-403 Would it make any difference whether the patent of the acquired company was purchased from a third party or developed as a by-product from in-house expertise?



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